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No. 94-1041

Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1994

JACK R. HAWKINS AND CYNTHIA HAWKINS, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether punitive damages awarded in litigation under state law are excluded from gross income under Section 104(a)(2) of the Internal Revenue Code as "damages received * * * on account of personal injuries or sickness" (26 U.S.C. 104(a)(2)).

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-21a) is reported at 30 F.3d 1077. The opinion of the district court (Pet. App. 22a-23a) is reported at 93 U.S. Tax Cas. (CCH) ¶ 50,208.

JURISDICTION

The judgment of the court of appeals (Pet. App. 24a) was entered on July 19, 1994. The petition for rehearing was denied on September 13, 1994 (Pet. App. 25a). The petition for a writ of certiorari was filed on December 9, 1994. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioners insured an $8,000 automobile with Allstate Insurance Company (Allstate). The terms of the policy required Allstate to provide petitioners with a comparable vehicle in the event of an accident. Petitioner Cynthia Hawkins was involved in an accident in 1979 which rendered the insured automobile a total loss (Pet. App. 2a). Under their policy with Allstate, petitioners requested a replacement vehicle of equivalent value. Instead of providing such a vehicle, Allstate allegedly pressured petitioners into purchasing an inferior, less expensive automobile (*ibid.*).

Petitioners then filed suit in Arizona state court alleging that Allstate had breached a common law duty of good faith and fair dealing (Pet. App. 2a). The complaint requested (i) compensatory damages for Allstate's failure to provide the promised insurance benefits, (ii) compensatory damages for the mental and emotional distress that petitioners allegedly suffered and (iii) punitive damages in an amount appropriate to punish Allstate (*ibid.*).

The case was tried to a jury. The jury returned a verdict awarding $15,000 in compensatory damages and $3,500,000 in punitive damages to petitioners (Pet. App. 2a). The Arizona Supreme Court upheld the jury verdict. *Hawkins* v. *Allstate Insurance Co.*, 733 P.2d 1073, 1077-1078, cert. denied, 484 U.S. 874 (1987).

2. Petitioners initially reported the punitive damages award (net of attorneys' fees) as income on their 1988 federal income tax return. They subsequently filed an amended return to claim that the award of punitive damages was excludable from gross income under Section 104(a)(2) of the Internal Revenue Code as "damages received * * * on account of personal injuries

or sickness" (26 U.S.C. 104(a)(2)).[1] When the Internal Revenue Service denied the refund claim, petitioners commenced this suit in federal district court (Pet. App. 2a).

3. The district court granted petitioners' motion for summary judgment and ordered a refund of the taxes they had paid on the punitive damages award. The court held that the punitive damages award was excludable from gross income under Section 104(a)(2) as "damages received * * * on account of personal injuries" because "personal injuries were a requisite for the award of punitive damages in the underlying action" (Pet. App. 23a).

4. The court of appeals reversed (Pet. App. 1a-21a). The court followed the reasoning of *Commissioner* v. *Miller*, 914 F.2d 586 (4th Cir. 1990), and *Reese* v. *United States*, 24 F.3d 228 (Fed. Cir. 1994), in concluding that punitive damages are not excluded from income under Section 104(a)(2) as damages received "on account of personal injuries" (26 U.S.C. 104(a)(2)). The court held that punitive damages are not awarded "on account of personal injuries" but are instead "awarded 'on account of' the tortfeasor's egregious conduct" (Pet. App. 6a).

The court explained that the history and structure of Section 104(a)(2), as well as its plain language, reflect that this statute is designed to provide a tax-free recovery of amounts that merely compensate injured persons for the losses they have incurred from personal injuries (Pet. App. 11a, citing, *e.g.*, *Starrels* v.

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[1] Petitioners initially reported $2,937,406 on their 1988 return as income from their litigation with Allstate. This figure consisted of the punitive damages award net of attorneys' fees. When petitioners filed an amended return to exclude the punitive damages award, they sought a refund of $793,277 (Pet. App. 2a).

Commissioner, 304 F.2d 574, 576 (9th Cir. 1962)). Punitive damage awards, by contrast, represent a windfall gain to the tort plaintiff. They are designed to punish the tortfeasor, not to compensate the plaintiff (Pet. App. 12a). The court concluded that punitive damages awards do not come within either the express language or the evident purpose of the statutory exclusion from income provided by Section 104(a)(2) (Pet. App. 13a).

Judge Trott filed a dissenting opinion in which he concluded that the plain language of Section 104(a)(2) requires exclusion of punitive damages awarded in any personal injury case (Pet. App. 14a-21a). He reasoned that, so long as the underlying claim is based upon a personal injury, any damages recovered from that claim are excluded from income by the statute (Pet. App. 14a).

ARGUMENT

1. The issue presented in this case has been addressed by the parties in the briefs filed in *Commissioner* v. *Schleier*, No. 94-500, which is scheduled for argument on March 27, 1995. In *Schleier*, the government contends that liquidated damages under the Age Discrimination in Employment Act of 1967—like punitive damages at common law—are awarded on account of the employer's willful misconduct, not "on account of personal injuries," and are therefore not excluded from income under Section 104(a)(2).[2] Because the Court's decision in *Schleier* may provide guidance for the proper disposition of the present case, it would be appropriate for the Court to hold this petition pending disposition of *Schleier*.

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[2] The government's brief in *Schleier* cites and relies on the decision of the Ninth Circuit in the present case, as well as the decisions of the Fourth and Federal Circuits in *Miller* and *Reese*. See 94-500 Pet. Br. at 26-34.

2. a. The application of Section 104(a)(2) to common law punitive damages awards may not be addressed by the Court in *Schleier*, for there is an independently sufficient basis on which the Court could dispose of that case. See 94-500 Pet. Br. at 26 n.16. If the Court does not reach the question whether liquidated and punitive damages are awarded "on account of personal injuries" in *Schleier*, we agree with petitioner that the petition in this case should then be granted.

In *Horton* v. *Commissioner*, 33 F.3d 625 (1994), the Sixth Circuit held that punitive damages received in a Kentucky personal injury suit are excludable from gross income. In so holding, the court expressly disagreed with the interpretation of Section 104(a)(2) adopted by the Fourth Circuit in *Commissioner* v. *Miller*, *supra*, the Federal Circuit in *Reese* v. *United States*, *supra*, and the Ninth Circuit in the present case. See 33 F.3d at 630 nn.9 & 11.[3] The Sixth Circuit further attempted to distinguish the facts of *Horton* from the present case on the theory that punitive damages in Kentucky (unlike punitive damages in Arizona) are awarded partly as compensation for the injury. See *id.* at 631-632. As petitioners observe (Pet. 11 n.9), however, the Sixth Circuit's effort in *Horton* to distinguish punitive damages awards as "punitive" or "compensatory" on a state-by-state basis is unconvincing. As Judge Kennedy noted in dissent in *Horton* (33 F.3d at 632):

> I do not think that Kentucky's explanation of why the concept of punitive damages should not be discarded makes punitive damages in Kentucky somehow different from other states. The primary purpose of

[3] The dissenting judge in *Horton* stated, by contrast, that she agreed with the reasoning and conclusion of the Ninth Circuit in the present case. 33 F.3d at 632 (Kennedy, C.J., dissenting).

punitive damages is to punish the defendant and thus deter such conduct.

In any event, the Sixth Circuit's express rejection in *Horton* of the reasoning of the Fourth, Ninth and Federal Circuits establishes a conflict among the courts of appeals without regard to whether punitive damages are characterized as "punitive" or as "in part serv[ing] a compensatory function" (33 F.3d at 631).

b. The proper application of Section 104(a)(2) to punitive damages awards is a recurring question of substantial administrative importance. This issue potentially arises every time a taxpayer receives a punitive damages award. Because punitive damages awards are often substantial, the proper treatment of such awards under Section 104(a)(2) often involves substantial tax obligations. Since the courts of appeals have disagreed in their interpretation of the statute, repetitive and wasteful litigation of this question is certain to occur absent an authoritative resolution by this Court.

We further agree with petitioners (Pet. 22) that the question presented in this case has continuing significance even after the amendment to Section 104(a)(2) that is effective for tax years after 1989. In 1989, the statute was amended to provide that its exclusion from income "shall not apply to any punitive damages [received] in connection with a case not involving physical injury or physical sickness." 26 U.S.C. 104(a) (Supp. V 1993). See Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, Tit. VII, § 7641(a), 103 Stat. 2379. In *United States* v. *Burke*, 112 S. Ct. 1867, 1871 n.6 (1992), the Court suggested that this amendment "allow[s] the exclusion of punitive damages [in] physical injury [cases]" after 1989. That question, however, was not presented in *Burke* and

had not been addressed by the parties in that case. The Court's statements on that issue in *Burke* were therefore dicta. Moreover, as we explained in our brief in *Schleier*, the amendment enacted by Congress in 1989 was designed to preclude application of the exclusion to punitive damages received in non-physical injury cases but was silent as to the taxation of punitive damages received in physical injury cases. See 94-500 Pet. Br. at 33-34 n.22.[4] With respect to the taxation of punitive damages awards in physical injury cases, Congress left the law as it existed *before* the 1989 amendment was enacted and made no attempt to declare how that law is to be applied. See *ibid.*; Douglas A. Kahn, *Taxation of Punitive Damages Obtained in a Personal Injury Claim*, 65 Tax Notes 487, 489-490 (1994). Resolution of the proper application of Section 104(a)(2) to punitive damages awards in the present case would thus be determinative for punitive damages awards in all physical injury cases both before or after 1989. It would also be determinative for such awards in non-physical injury cases before 1989, for the 1989 amendment resolves only the application of this statute to punitive damages awards in non-physical injury cases *after* 1989.

Because the proper application of Section 104(a)(2) to punitive damages awards represents a substantial recurring issue on which the courts of appeals have divided, the petition in this case should be granted if that issue is not resolved in the Court's decision in *Schleier*.

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[4] We have furnished a copy of our brief in *Schleier* to petitioners' counsel in this case.

CONCLUSION

The petition for a writ of certiorari should be held pending this Court's disposition of *Commissioner* v. *Schleier*. In the event the issue presented in this case is not resolved in *Schleier*, the petition should be granted.

Respectfully submitted.

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